

DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 05-0398
Income Tax
Tax Period 1999-2002

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ISSUES

I. Gross Income Tax-Rate of Tax on Directory Advertising

Authority: IC § 6-8.1-5-1(b), IC § 6-2.1-2-2(a), IC § 6-2.1-2-2, IC § 6-2.1-2-4.
The taxpayer protested the imposition of the high rate on the income from directory advertising.

II. Gross Income Tax-Bad Debt Deduction

Authority: IC § 6-2.1-4-2, IC § 6-2.5-6-9(a).
The taxpayer protested the disallowance of the bad debt deduction.

III. Gross Income Tax-Imposition of Tax on Interstate Long Distance Revenue

Authority: IC § 6-2.1-2-2(a), IC 6-2.1-3-3.
The taxpayer protested the imposition of tax on interstate long distance revenue.

IV. Gross Income Tax-Accounting Issue

Authority: IC § 6-2.1-2 et seq.
The taxpayer protested the numbers in the audit report.

V. Gross Income Tax-Annual Operating Deduction

Authority: IC § 6-2.1-4-1(a).
The taxpayer protested the disallowance of the annual operating deduction.

VI. Gross Income Tax-Imposition of Tax on Internet Access Revenue

Authority: IC § 6-2.1-2-2(a), Internet Freedom Act Pub. L.105-277 (1998).
The taxpayer protested the imposition of tax on internet access revenue.

VII. Gross Income Tax-Imposition of Tax on Interest Income

Authority: IC § 6-2.1-2-2(a).

The taxpayer protested the imposition of tax on certain interest.

VIII. Tax Administration- Ten Percent Negligence Penalty

Authority: IC § 6-8.1-10-2.1, 45 IAC 15-11-2(b), 45 IAC 15-11-2(c).

The taxpayer protested the imposition of the negligence penalty.

Statement of Facts

The taxpayer is a corporation providing telephone service. The taxpayer has a wholly owned subsidiary providing internet service. The taxpayer filed amended returns requesting refunds for the tax years 1999-2001. After an audit, the Indiana Department of Revenue (department) denied the refund requests for 1999 and 2000, and assessed additional gross income tax, penalty, and interest for the years 2001 and 2002. The taxpayer protested the assessment and denials of claims for refund. Prior to hearing, the taxpayer and department resolved the issues concerning the reporting of interest expense and the recording of the income of the wholly-owned subsidiary. A hearing was held on the remaining issues and this Letter of Findings results.

I. Gross Income Tax-Rate of Tax on Directory Advertising

Discussion

The department assessed gross income tax at the high rate on the taxpayer's receipts from the sale of ads and other business listings for inclusion in the taxpayer's business directory. The taxpayer protested this assessment contending that the directory advertising receipts are advertising receipts taxable at the low rate.

Notices of proposed assessments are prima facie evidence that the department's claim for unpaid taxes is valid. IC § 6-8.1-5-1(b). The taxpayer has the burden of proving that the department incorrectly imposed the assessment. Id.

During the tax period, Indiana imposed a tax on the gross receipts of a business. IC § 6-2.1-2-2(a). The rate of tax was determined by analyzing the type of transaction from which the receipts derived. IC § 6-2.1-2-2. Revenue received from display advertising was taxable at the low rate. IC § 6-2.1-2-4. The issue to be determined is whether the receipts on which gross income tax was assessed at the high rate were actually receipts from display advertising and therefore taxable at the low rate.

"Display advertising" is defined at 45 IAC 1.1-2-3 as follows:

- (a) As used in section 2 of this rule, "display advertising" includes:
 - (1) outdoor billboards;

- (2) outdoor posters;
 - (3) outdoor painted displays;
 - (4) print media advertising; and
 - (5) the sale of time by a radio station, a television station, and a cable television operator.
- (b) The term does not include the following:
- (1) The rendering of professional services in connection with such advertising.
 - (2) The sale or rental of tangible property that will be used in display advertising. Examples of such tangible property include the following:
 - (A) Real estate.
 - (B) Painted signs.
 - (C) Electric signs.
 - (D) Neon signs.
 - (E) Novelties.
 - (F) Handbills.
 - (G) Cards.

Listings and advertisements in the business directory are not specifically listed in the Regulation. They definitely are not, however, receipts for personal services or the sale or rental of an item with the advertisement placed on it such as the items listed under (b)(2). Rather taxpayer's advertisements and listings are most similar to the advertising in print media such as newspapers. Listings and advertising in the telephone business directory qualified as display advertising for purposes of the gross income tax. Therefore, the revenues were taxable at the low rate.

Finding

The taxpayer's protest is sustained.

II. Gross Income Tax-Bad Debt Deduction

Discussion

Taxpayers who report on an accrual basis are able to deduct bad debts from their gross income in the same manner that they deduct bad debts from gross income for sales and use tax purposes. IC § 6-2.1-4-2. That method is set out at IC § 6-2.5-6-9(a) as follows:

- [A] retail merchant shall deduct from his gross retail income from retail transactions made during a particular reporting period, an amount equal to his receivables which:
- (1) resulted from retail transactions in which the retail merchant did not collect the state gross retail or use tax from the purchaser;
 - (2) resulted from transactions on which the retail merchant has previously paid the state gross retail or use tax liability to the department; and
 - (3) were written off as an uncollectible debt for federal tax purposes during the particular reporting period.

The taxpayer produced substantial documentation indicating that it took the bad debt deductions correctly.

Finding

The taxpayer's protest is sustained.

III. Gross Income Tax-Imposition of Tax on Interstate Long Distance Revenue

Discussion

Pursuant to IC § 6-2.1-2-2(a), the department assessed gross income tax on the taxpayer's revenue from interstate long distance calls. IC § 6-2.1-3-3 exempted revenues from the gross income tax if the imposition impeded interstate commerce and therefore violated the United States Constitution. The taxpayer argued that the receipts from interstate long distance calls qualified for this exemption from the gross income tax.

Here the gross income tax was imposed on a taxable transaction that took place in Indiana, the making of a long distance phone call from a phone in Indiana. The fee for the long distance call was billed to an Indiana address. No other state could impose an income tax on this revenue received by the taxpayer, an Indiana company, for providing a service to an Indiana customer that took place in Indiana and was billed to an Indiana address. Therefore, the imposition of the gross income tax on the taxpayer's revenues from long distance calls did not impede interstate commerce.

Finding

The taxpayer's protest is denied.

IV. Gross Income Tax-Accounting Issue

Discussion

The taxpayer contends that the department used the wrong number for intrastate-interlata long distance revenue in determining the amount of gross income tax properly due to the state. The taxpayer did not sustain its burden of proving that an error was made. The department computed the gross income tax due pursuant to the provisions of IC § 6-2.1-2 et. seq.

Finding

The taxpayer's protest is denied.

V. Gross Income Tax-Annual Operating Deduction

Discussion

IC § 6-2.1-4-1(a) provided an annual \$1,000.00 deduction to each business subject to the gross income tax. The taxpayer protested that the department did not give it the benefit of this annual operating deduction. The taxpayer was entitled to the statutory annual deduction.

Finding

The taxpayer's protest is sustained subject to audit verification.

VI. Gross Income Tax-Imposition of Tax on Internet Access Revenue

Discussion

The department assessed gross income tax on the taxpayer's receipt of revenue from internet access fees under authority of IC § 6-2.1-2-2(a). The taxpayer protested this assessment claiming that the revenues were exempt from state taxation pursuant to the Internet Freedom Act Pub. L. 105-277 enacted October 21, 1998, and extended until November 1, 2003, by Pub. L. 107-75.

Section 1101(a) of the Act provided for a moratorium for taxes on internet generated income "generally imposed and actually enforced prior to October 1, 1998." The taxpayer contended that the gross income tax was not actually imposed on internet access fees or alternatively not actually enforced prior to October 1, 1998.

In support of this contention, the taxpayer stated that there was no specific provision in the law imposing the gross income tax on internet access fees. Indiana enacted the gross income tax in 1933. It is imposed on "the entire taxable gross income of a taxpayer who is a resident or domiciliary of Indiana;" IC § 6-2.1-2-2(a)(1) The imposition is clearly on all income earned. It would have been impossible for the law to specifically include all of the types of income subject to the tax. Further, internet access fees could not have been specifically included as taxable because internet fees did not exist in 1933. After the introduction of internet services, no specific statute exempting revenue from internet access fees was enacted excluding that variety of revenue from the gross income tax.

The taxpayer also argued that the tax was not enforced prior to October 1, 1998, and cited Section 1101(d) of the Act which states:

For purposes of this section, a tax has been generally imposed and actually enforced prior to October 1, 1998, if before that date, the tax was authorized by statute and either –(1) a provider of Internet access services had a reasonable opportunity to know by virtue of a rule or other public proclamation made by the appropriate agency of the State or political subdivision thereof, that such agency has interpreted and applied such tax to Internet access services; or (2) a State or political subdivision thereof generally collected such tax on charges for Internet access.

The taxpayer supported its contention that the law was not enforced because it is aware of business concerns that did not declare internet access fee revenues as subject to the gross income tax and their returns were accepted by the department. Acceptance of an erroneous return does not indicate that the department agrees with the error contained therein. The department performed audits to determine if taxpayers were complying with the tax statutes of the state. In this case, the department audited the taxpayer and determined that it did not comply with the gross income tax imposition statute because it did not report the internet access fees as subject to the gross income tax. Therefore, the department properly assessed gross income tax on the internet access fees.

Finding

The taxpayer's protest is denied.

VII. Gross Income Tax-Imposition of Tax on Interest Income

Discussion

The department imposed additional gross income tax on interest income pursuant to IC § 6-2.1-2-2(a). The taxpayer protested this assessment contending that the interest on which the department assessed tax was not interest income. Rather the amounts on which the tax was assessed were actually interest payments made to customers. The taxpayer produced a "General Ledger Detail Report" for the year 2002 which included several highlighted items of interest paid to customers. The taxpayer does not owe gross income tax on these interest expenses paid.

Finding

The taxpayer's protest is sustained subject to audit verification.

VII. Tax Administration- Ten Percent Negligence Penalty

Discussion

The taxpayer protests the imposition of the ten percent negligence penalty pursuant to IC § 6-8.1-10-2.1. Indiana Regulation 45 IAC 15-11-2 (b) clarifies the standard for the imposition of the negligence penalty as follows:

Negligence, on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

The standard for waiving the negligence penalty is given at 45 IAC 15-11-2 (c) as follows:

The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section. Factors which may be considered in determining reasonable cause include, but are not limited to:

- (1) the nature of the tax involved;
- (2) judicial precedents set by Indiana courts;
- (3) judicial precedents established in jurisdictions outside Indiana;
- (4) published department instructions, information bulletins, letters of findings, rulings, letters of advice, etc;
- (5) previous audits or letters of findings concerning the issue and taxpayer involved in the penalty assessment.

Reasonable cause is a fact sensitive question and thus will be dealt with according to the particular facts and circumstances of each case.

The taxpayer failed to establish that its failure to pay the gross income tax was due to reasonable cause.

Finding

The taxpayer's protest to the imposition of penalty is denied.